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IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1997

Bowater Incorporated and Subsidiaries,
Petitioner,

v.

Commissioner of Internal Revenue,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS CURIAE*

The National Association of Manufacturers (the "NAM") is the nation's oldest and largest broad-based trade association. Its more than 14,000 member companies and

* Pursuant to S. Ct. R. 37.6, counsel for *amicus curiae* state that this brief was not authored in whole or in part by a party and that no person or entity, other than the *amicus curiae*, its members and its counsel, made a monetary contribution to the preparation or submission of this brief.

subsidiaries, including 10,000 small manufacturers, employ approximately eighty-five percent of all manufacturing workers and produce over eighty percent of the nation's manufactured goods. More than 158,000 additional businesses are affiliated with the NAM through its Associations Council and National Industrial Council. Approximately eighty percent of NAM members are engaged in exporting or foreign direct investment, and the NAM's interest in the question of interest allocation is consistent with that of those members.

The issue before the court is whether the proper interest expense to be allocated and apportioned, pursuant to Treas. Reg. § 1.861-8(e), is net interest expense (gross interest expense minus offsetting interest income) or gross interest expense. The NAM is well-situated to address this issue. Many NAM members earn foreign source income and must comply with the regulations implementing I.R.C. § 861 to calculate foreign tax credit and/or Foreign Sales Corporation ("FSC") benefits.[1]

STATEMENT OF THE CASE

Amicus adopts the statement of the case and facts as set forth by Petitioner.

SUMMARY OF ARGUMENT

In *Bowater, Inc. v. Commissioner*, 108 F.3d 12 (2d Cir. 1997), the Second Circuit overturned the decision of the Tax Court and determined that the proper amount of interest to be

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[1] The Parties' written consent to the submission of this brief is on file with the Court.

allocated and apportioned under Treas. Reg. section 1.861-8(e) is gross interest expense. This holding is in direct conflict with the Fifth Circuit's decision in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), followed by the Tax Court in *Bowater*, which held that the appropriate measure of interest was net interest expense. *See Bowater, Inc. v. Commissioner*, 101 T.C. 207, 212, 214 (1993). The resolution of this split among the circuits is critically important because, although *Bowater* involves calculation of Domestic International Sales Corporation ("DISC") benefits and an earlier version of the regulations, substantially similar regulations currently govern the interest allocation crucial to a number of other calculations required by the tax code, most notably the calculation of foreign tax credit and FSC benefits. As illustrated by a recent NAM survey, hundreds of millions of dollars are at stake pending the resolution of this issue based on those two calculations alone.

ARGUMENT

I. THE SECOND CIRCUIT'S DECISION IN *BOWATER* IS AT ODDS WITH THE FIFTH CIRCUIT'S DECISION IN *DRESSER* AND THE RESOLUTION OF THIS ISSUE IS RELEVANT TO THE CALCULATION OF LIMITATIONS AND BENEFITS UNDER NUMEROUS INTERNAL REVENUE CODE SECTIONS

In 1990, the Fifth Circuit concluded in *Dresser* that the proper measure of interest to be allocated and apportioned under the regulations was net interest. The Second Circuit specifically declined to follow the *Dresser* holding when

deciding *Bowater*.

The Fifth Circuit, noting that the regulations specified the *method* of allocating interest expense but not the *amount* of interest expense,[2] determined that the fungibility concept underlying the regulation required the allocation of "the total *cost of the borrowing*," which, in the court's view, meant that interest paid and interest received should be netted against one another. The Second Circuit purported to rely on the plain language of the regulation and emphasized the required allocation to "all income producing activities" of the taxpayer, which it deemed to include the activity of producing interest income. Consequently, the court interpreted the regulation to require the allocation of the gross amount of interest expense since only a ratable portion would be allocated to the production of interest.

The Fifth Circuit correctly interpreted the concept of fungibility to ensure equality of treatment between similarly-situated taxpayers, regardless of management debt-structuring decisions. Resolution of the circuit conflict by this Court would ensure further that similarly-situated taxpayers are treated equally without regard to an accident of geography. If the current situation is allowed to persist, taxpayers located anywhere other than the Second Circuit will allocate net interest expense, while Second Circuit taxpayers will be forced to allocate gross interest expense.

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[2] *Dresser* involved the pre-1977 regulations, which differ slightly from those at issue in *Bowater*. However, there is no meaningful difference between the two versions. Both require the allocation of interest expense to all categories of gross income, and neither specifies whether such interest expense should be the net or gross amount. Additionally, the *Dresser* court expressly relied upon Treas. Reg. § 1.861-8(e)--the version applicable to *Bowater*--to support its holding. *Dresser* at 1135.

While the resolution of this issue in the instant case is relevant to calculation of DISC benefits, the proper method for apportioning interest expense is not limited to computation of DISC income. It is a pervasive concept affecting numerous determinations under the Code. I.R.C. section 861(b) and its implementing regulations govern the allocation of a variety of expenses, including interest expense, to determine a taxpayer's domestic-source and foreign-source income. Two of the areas in which these calculations have significant current applicability are the determination of foreign tax credit and Foreign Sales Corporation (FSC) benefits.

Although the Treasury Department amended the regulations again in 1988 such that they now appear on their face to moot the issue in the current case, the NAM agrees with the Justice Department and the Second Circuit that the new temporary regulation "simply serves to clarify the Commissioner's position" and that it "merely reiterates, or clarifies, the Regulation at issue here" and does not effect a change in the rules. Brief for the United States at 11, *Bowater, Inc. v. Commissioner*, 108 F.3d 12 (2d Cir. 1997); 108 F.3d at 17. Consequently, the new temporary regulation has little impact on the issue in the present case.

II. THIS ISSUE IS IMPORTANT TO U.S. MANUFACTURERS FOR THE CALCULATION OF THEIR U.S. TAX LIABILITY

As mentioned above, the allocation and apportionment of interest under Treas. Reg. § 1.861-8(e) is an integral step in the calculation of foreign tax credit and Foreign Sales Corporation ("FSC") benefits. Both of these provisions have a tremendous impact on the tax liability of U.S. companies

involved in exporting and foreign direct investment.

For example, in 1994 U.S. taxpayers claimed foreign tax credits totalling in excess of $25 billion. *See* Internal Revenue Service, 16 Statistics of Income Bulletin 204, Table 13 (Spring 1997). Foreign tax credit computation has a substantial effect on the tax liability of all U.S. companies with significant overseas operations.

Additionally, for Tax Year 1992, Foreign Sales Corporations filed 3,073 income tax returns, representing $152.3 billion in gross receipts. Eighty-six percent of all FSC returns filed were attributable to the export of manufactured products. *See* Internal Revenue Service, 17 Statistics of Income Bulletin 114, (Summer 1997). This translates into approximately $121.8 billion in gross receipts attributable to the export activities of just the manufacturing community.

A limited survey was sent this fall to representative NAM member companies in a wide cross-section of manufacturing industries, with a 24% response rate. Given that the average response rate to a mailed, voluntary survey is approximately 10%, the 24% response rate provides a statistically meaningful sample and can provide a basis for drawing valid conclusions. Of the respondents, 58 percent determined that the resolution of this issue would have an impact on their companies' tax liability for years ranging from 1979 to the present. For all of these companies, the interest allocation amount is relevant to the calculation of FSC and/or foreign tax credit benefits.[3]

The survey results also revealed that the proper measure of interest expense to be allocated under section 1.861-8(e) is

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[3] *See* App. A for complete survey results.

an important issue for more than half (fourteen) of the respondents, and, for more than half (eight) of those companies, the amount of money at issue exceeds $10 million per company. For six companies, the amount of potential tax liability exceeds $20 million per company. Even using the most conservative estimates, the aggregate amount of potential tax liability for just these eight companies exceeds $140 million.[4]

The substantial impact of this issue on the tax liability of U.S. manufacturers engaged in exporting and foreign direct investment, as demonstrated by the NAM survey and relevant income statistics, is strong evidence of the need for this Court to resolve the conflict among the circuits. The determination of how much of their foreign tax liability will be creditable against their U.S. tax liability has a direct impact on the profitability and competitiveness of U.S. companies in the global marketplace. Manufacturers that can be certain of the tax treatment of interest income and expense through this Court's ruling in this case will be in a better position to compete and grow worldwide.

CONCLUSION

The Second and Fifth Circuit Courts of Appeal have issued conflicting opinions regarding whether the proper measure of interest to be allocated under the section 861 regulations should be net or gross interest expense. As the resolution of this issue is significantly important to many U.S. multinationals and will substantially affect both the

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[4] The estimates used were $10 million for each company in the "$10 - $20 million" range and $20 million for each company in the "More than $20 million" range: (2 x $10 million) + (6 x $20 million) = $140 million.

prospective calculation of their U.S. tax liability and their potential retroactive liability on audit, the NAM urges that the writ of certiorari be granted.

Respectfully submitted,

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APPENDIX A

NAM Interest Allocation Survey Results
as of October, 1997

1. Annual sales of your company: **24 responding**

❑	Less than $5 million	**0**
❑	$5 million - $10 million	**2**
❑	$11 million - $49 million	**1**
❑	$50 million - $249 million	**0**
❑	$250 million - $1 billion	**1**
❑	More than $1 billion	**20**

2. Is the gross versus net interest calculation relevant to your company with regard to any issue currently under audit or for any open year? **24 responding**

❑ Yes **14** ❑ No **10**

3. If so, to what issues is this computation relevant? **15 responding**

❑	Computation of DISC benefits	**0**
❑	Computation of FSC benefits	**11**
❑	Computation of foreign tax credits	**11**
❑	Other (specify)_____	**0**

4. In what tax years is this issue relevant?

1995-97 (1)
1979-85 (1)
1993-1994 (1)
1992 to present (2)
1994 to present (2)
all open years (1)
1979-86 (1)
1988 to present (2)
1990 to present

5. What is your company's range of potential liability relevant to this issue? **14 responding**

❑	Less than $1 million	**4**
❑	$1 - $10 million	**1**
❑	$10 - $20 million	**2**
❑	More than $20 million	**6**
	Unknown	**1**